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Introduction

Decentralization of government is one of the key components of Ukrainian economic, legal and political reforms implemented after the country had gained independence. The idea of decentralization has strong and broad support throughout Ukrainian society. Initially such support was based on the negative memory of overcentralization in the Soviet period, and was later reinforced by the recent frustration over the performance of the national government in Kiev, i.e., its inability to overcome political gridlock and to implement much needed reform policies. The central government, in its turn, welcomes an opportunity to share responsibilities with the regional authorities. However, a consensus which favors decentralization in principle coexists with a considerable disagreement over the specifics of allocating resources and functions between levels of the government, and over mechanisms and procedures of intergovernmental interaction.

Legal foundations for a decentralized system of government have been laid by the Ukrainian Constitution and a panoply of laws, some of which have already been passed and others of which are being drafted and/or debated. While Ukraine's political choice is for a unitary state, its political system provides for independently elected legislatures at the regional (oblast) and municipal levels, and for local "self-governments" that are not parts of the central government's apparatus.

However, the decentralization of government that has taken place in Ukraine is failing to produce the expected results. While this is partly attributable to the continuing economic recession and political instability in the country, numerous misconceptions and imbalances in the allocation of revenues and expenditures between the tiers of government are themselves among the major causes of the related crises in Ukrainian economics, finance and politics.

An efficient system of decentralized government should meet a number of basic requirements, which could be summarized as follows:

A reasonable balance between financial resources and responsibilities at each level of government
Administrative efficiency, including:
- clarity;
- transparency; and
- predictability

Economic efficiency, including:
- efficient allocation of public sector functions, revenues and expenditures between tiers of government;
- efficient provision of public goods and services;
- market efficiency - minimal distortion of market signals and incentives, favorable investment climate

equity

If these requirements are not properly met, decentralization of government, instead of providing the benefits it promises, becomes a source of economic losses, mismanagement and political tension. A poorly conceived and implemented decentralization dilutes responsibilities, makes government less transparent, breeds lobbying and ad hoc bargaining, entails heavy efficiency losses, and produces profound interregional disparities.

The main problem of the Ukrainian system of decentralized government and intergovernmental finance is that it blends half-reformed institutions and approaches of the Soviet period with recently crafted political compromises. The first few years of Ukrainian independence were a period of "institutional preservation rather than institutional engineering" (Wolczuk, 1998), and subsequent changes were driven more by political and administrative expediency than by the above-listed and requirements of administrative, economic and social efficiency.

These requirements are of a rather general nature and are sufficiently broad to accommodate a nation's political choices and preferences, its economic realities and other idiosyncratic features. In the case of Ukraine such features include profound structural deformations inherited from the period of Soviet planning, other path dependencies, and numerous imperfections and omissions in the country's institutional setup. These specifics should be taken into account in an analysis of the existing system and in policy proposals for future reforms.

Economic conditions and institutional background

Structural distortions in the Ukrainian economy result from the non-market principles and investment policies that dominated in Ukraine over seven decades. These policies emphasized development of heavy industries, excessive concentration of production, and were subordinated to the needs of the Soviet military-industrial complex that had many of its facilities located in Ukraine. Disregard of cost efficiency made overemployment endemic among Ukrainian enterprises. Urbanization was concurrent with, and driven by, Soviet-style industrialization, which strongly affected the distribution of population and labor among industries, regions and types of settlements.

Overall, the Ukrainian economy is characterized by a profound misallocation of physical capital and human resources. Occupational and residential choices determined during the Soviet period cannot be sustained under the market conditions. For the country's public finances it entails a double jeopardy, because a heavily distorted economy, being unable to provide the public sector with an adequate tax base, calls at the same time for massive subsidies and transfers to households lacking access to market sources of income. This mismatch is particularly acutely felt at lower tiers of government, which are responsible for provision of social services and safety nets.

Revenue collection is further complicated by steadily growing non-payments and widespread barter transactions, which are effectively non-taxable. In 1997, inter-enterprise arrears exceeded the country's GDP, whereas barter transactions for the same year were over 70% of the GDP (Ukrainian ... , 1998; Financial Times, May 5, 1998). The mushrooming informal sector, which includes the shadow economy, "cottage industries" and other forms of subsistence activities, is out of reach of the taxman as well. At the same time the expenditure side of the public sector is burdened by an extensive system of social services and safety nets. This system, which is another part of the Soviet legacy, was adequate for a command economy but is hypertrophied and clearly unaffordable for a crisis-stricken market economy. The unrealistic expectations that such a system could be sustained are upheld by the Ukrainian constitution, which guarantees a broad set of "positive" economic rights, including rights to personal development, employment, free education and acceptable living standards. Again, local governments are the first to be confronted with these excessive entitlements.

There are profound interregional economic disparities, already present at the beginning of the market reform, and later sustained and even exacerbated by deficiencies in the Ukrainian institutional setup, which blocks much-needed economic restructuring. An example of such deficiencies is the poor state of the labor and real estate markets, which restrains spatial mobility of the population and prevents people from moving to areas with better economic opportunities. It is estimated that only 10% of Ukrainian population have the means to afford a relocation (interview with Bohdan Krawchenko, Ukrainian Academy for Public Administration, May 19, 1998). These economic and institutional barriers are compounded by administrative restrictions imposed by the system of residency registration, which has been preserved from the Soviet past. As a result, the spatial economic inequality in Ukraine becomes chronic. In Kiev, the most prosperous of the regions, tax revenue per capita is at least twice as high as in every other region of the country, and seven times higher than in the poorest region (Zakarpatska). These disparities are to a significant extent alleviated by unprecedentedly broad interregional redistribution of tax revenue to support depressed areas.

Legal foundations of intergovernmental public finance

The centerpiece of the legal foundations for decentralized government in Ukraine is the country's Constitution, which establishes the territorial division of Ukraine, includes provisions for local state administrations and local self-government, and for independently elected regional legislatures. Local budgets are assigned by the Constitution to the jurisdiction of lower-level governments. At the same time the Constitution does not confer sovereign rights on sub-national units, which would have been a contradiction with Ukraine's status as a unitary state. While this fundamental choice was apparently prompted by concerns about the unity of a newly independent nation, it allows Ukraine to escape the pitfalls of federal states with unstable political systems, lack of constitutional culture, and reforming and/or developing economies. The experiences of such states, including Russia, suggests that provinces often use their political and economic clout for wresting from the federal government unilateral concessions, subsidies, exclusive legal and economic regimes, all of which erode the policy-making capacity of the center.

Constitutional provisions for decentralized government in Ukraine are further specified in a number of supplementary laws, some of which have been passed recently, some of which existed before the Constitution was enacted in 1996 and now require amendments, and others of which are still pending. Central among these are the Law on Local Self-government and Law on Local State Administration (the latter, after having been vetoed by the President, is currently debated at the parliament). The earlier Law on Budget System and Law on System of Taxation are still to be amended in order to be brought in compliance with the Constitution. The official Concept of Administrative Reform in Ukraine provides for new laws On Self-government Finance, On Local Taxes and Duties, and On Financial Equalization of Territories. Specifics of intergovernmental finance for a given fiscal year, most notably the allocation of shared taxes and equalization transfers, are provided by annual Laws on State Budget of Ukraine. Tax laws, in particular the Law on VAT and Law on Profit Tax, also include important provisions for intergovernmental public finance.

In the system of government established by these laws, the intergovernmental divides-- between executive and legislative branches, between the center and subnational units, and between state administration and local self-government--are peculiarly interwoven. Ukraine features a deconcentrated system of state executive power (vlastna vertical') with full vertical subordination, plus a three-layer system of mutually independent legislatures. The latter are relatively strong at the top level, and much less significant at lower levels. At the level of oblasts and rajons (municipal units), the legislatures, according to the Constitution and Law on the Local Self-government, are viewed as a part of the system of local self-government, whereas executive bodies represent the state administration. At the level of cities, settlements and villages, both legislatures and executives are nominally outside of the state administration. However, local executive committees have to interact in an unspecified way with local state administrations that represent the central government. The existing legislation, while providing for such interaction, offers no procedures to resolve competence issues over shared responsibilities (Martinez-Vazquez et al., 1995). This confusion has already produced a number of constitutional conflicts, e.g. the controversy over roles and division of responsibilities between the head of council of city of Kiev, who assumed executive functions according to the Law on Local Self-government, and the head of city's State Administration appointed by the president (Tkachuk et al., 1997).

Overlapping and poorly outlined responsibilities create disorient politicians and public officials about roles, functions and modes of interaction of different parts of the government. Constitutionally mandated "interaction" between local state administrations and local self-governments makes the latter almost entirely fiscally dependent on the state. This is hard to reconcile with the provision of the Law on Local Self-government which stipulates that budgets of local self-governments are independent from the state budget. This independence is thus just notional, not real.

Jurisdictions of subnational governments, outlined by the above laws, lack constitutional protection, and could be unilaterally amended by the central government. The Law on Local Self-Government provides that some powers and responsibilities of local governments could be transferred from the center (in which case the lower-level government serves as an agent of the central administration), whereas others are assigned to local governments exclusively. This creates two types of problems. First, the central government has a convenient option to 'delegate' to subnational governments responsibilities which it finds difficult, costly, or politically inexpedient to fulfill, as it happened with health, education, and social safety nets. Second, exclusive functions of local governments could be taken away with relative ease through amendments to existing legislation (Brown, McGuire, op. cit.) In other words, the Ukrainian constitution and public law in general do not ensure sufficient protection of institutions of decentralized government against political opportunism.

Ukrainian law does not assign any own sources of revenue to the intermediate layer of government, formed by oblasts and districts. Budgets of these territorial units, according to the Constitution and the Law on Local Self-government, are formed by the central government's transfers and the voluntary contributions of constituent cities and municipalities for interjurisdictional projects. Neither of these sources of revenue is reliable, and oblasts and districts are fully exposed to both arbitrary spending cuts by the center and free riding by municipalities. It is symptomatic that poorer communities are concerned that their rich neighbors will be reluctant to participate in oblast-wide joint ventures, and thus press for a higher degree of centralization of budget funds at the oblast level (Lyakh, Tkachenko, 1998).

The financial resources of subnational governments, as provided by the above laws, and in particular the laws on local self-government and on budget system, are based on fixed and regulated revenues, as well as by various transfers from upper-level governments. Fixed revenues come from 16 taxes assigned by national laws to local jurisdictions. Because of low-yield tax bases ('nuisance taxes') and nationally imposed restrictive caps on tax rates, these taxes are insignificant sources of revenue--in the order of several per cent of the budgets of lower-level governments (Kravchenko, 1997).

Regulated revenues are national taxes--corporate and personal income taxes, the value-added tax (VAT) and excises--that could be assigned in different proportions to subnational governments. Such proportions are established annually in budget laws, and are subject to change from one year to another. In the early period of independence the central government had complete discretion over such adjustments, and in 1993 and 1994 regional shares of regulated taxes were set separately for every oblast. This was a continuation of the Soviet tradition, in which the central government had undivided administrative and fiscal authority and was not subject to any formal constraints vis-a-vis territorial units. More recently there has been a tendency for discretion of the center to be restricted by establishing formal and uniformly applicable rules. Thus, in 1994 sharing rules--still subject to annual adjustments--were set by the budget law to be the same for all regions. In 1997, taxes that were previously shared between tiers of government were assigned exclusively to either the center (VAT) or regions (personal and corporate income taxes and excises). These changes have been reflected in amendments to the existing laws on VAT and corporate profit taxes (an amendment of the Law on Personal Income Tax is still pending), which presumably should make it more difficult to reverse the current arrangements in the future. While this adds predictability to the system of intergovernmental finance, the 1997 re-assignment of taxes opens up new sources of fiscal uncertainty, which will be discussed later in the paper.

In case of shortfall of local budget revenues in comparison with assigned responsibilities, a lower-level government can petition its upper-level counterparts for transfers (grants, subsidies and subventions). Some of these transfers are specified in the Budget Law, whereas others are disbursed on an ad hoc basis in the course of the fiscal year. The most important of these are subventions aimed at assisting poorer regions at the expense of those that are relatively wealthier. These subventions, envisaged by the Law on Budget System, serve the dual purpose of reducing both vertical and horizontal fiscal imbalances. While many countries have similar systems of equalization transfers, Ukraine is unusual in that such payments are not made out of the central government's general revenue, but instead from matching deductions from regulated revenues initially allocated for regions that are 'donors'. Existing legislation offers neither formulas nor other provisions for calculations of such subventions, which are subject to annual revisions. The lack of formal constraints imposed on subventions to oblasts erodes the legal and institutional foundations of the Ukrainian intergovernmental finance, because although some sources of revenue are assigned to regions by law, residual subventions are still assessed on an ad hoc basis. Given the growing importance of these subventions (from 8% of total revenues of subnational governments in 1993 to 21% in 1997 (Martinez-Vazquez, 1998)), the same conclusion to a large extent is true about regional revenues at large.

According to the law, regions can also borrow from upper-level budgets to compensate for short-term revenue gaps. In practice such "loans" are seldom repaid and turn out to be subsidies in disguise. An important feature of this system is that transfers from the upper-level government serve as a marginal source of revenue (The Road ... , 1998), which, as will be argued later, creates perverse fiscal incentives.

Assessment of the legal foundations of intergovernmental finance in Ukraine should include not only legislation itself, but also its role, place and relevance in the Ukrainian system of government, and in particular in budgetary processes. There are serious problems with regard to both the formal and informal aspects of the existing legal system, and these problems are often mutually aggravating. Weaknesses, inconsistencies and contradictions in the formal law undermine its authority and reinforce the widespread attitude that legislation has little relevance to everyday life. These sentiments, in their turn, lead to stillborn legislative acts that contain unrealizable provisions or are otherwise impractical and confusing.

Ukrainian public law, including the part pertaining to intergovernmental relations, preserves many features, patterns and structures of the Soviet system--arguably for the sake of continuity of government operations in the transition period. Legal and institutional innovations, in their turn, often reflect political compromises rather than consistently applied general principles of state building. For example, the relative weakness of regional legislatures is apparently a compensation for considerable restrictions of the President's power at the central level. These rationales and tradeoffs, however, are unrelated to the need for an efficient division of power, with resulting weaknesses in public administration.

Despite the efforts to advance legal reform, the rule of law in Ukraine remains weak both in the private and public domains. Decentralization of government is still broadly regarded in Ukraine as a means to facilitate bureaucratic control, with subnational governments considered as field offices of the center (Brown, McGuire, 1997). This view is inimical to the ideas of law-based intergovernmental relations, division of power and fiscal autonomy of lower-level governments.

The country lacks mechanisms to enforce legal and constitutional norms. Central and regional governments routinely renege on their commitments, including transfers to lower-level governments and wages of public sector employees. This, among other things, makes lower-level governments reluctant to rely on transfers from upper levels. Such commitments could easily be broken, and "there is an underlying suspicion among subnational governments that a greater reliance on transfers may lead to greater revenue uncertainty" (Martinez-Vazquez, 1998). Instead, subnational governments seek to secure their own sources of revenue and favor a segregated system of public finance. The recent assignment to regions of corporate and personal income taxes responds to these preferences. Such fiscal arrangements are in violation of the basic principles of intergovernmental public finance (see below), so that the weakness of the rule of law in Ukraine leads to considerable efficiency losses.

Discretion and bargaining, rather than rules, underpin a great deal of public-sector decisionmaking, including fiscal relations between the central and local governments. The political culture of bureaucratic "coordination" and lobbying, rooted in the Soviet past, continues to reign. While what is budgeted and otherwise provided by law is not assured in practice, there are numerous opportunities for quick fixes by extra-legal means. Under such circumstances, legal provisions do not affect intergovernmental fiscal relations directly, but instead serve as a point of departure for subsequent negotiations and lobbying activities.

The formal law is highly restrictive for lower-level governments, which have little discretion over their sources of revenue and tax rates, but at the same time are required to maintain costly social services and programs that are well beyond the means of local budgets. Necessary adjustments to reality are unspecified by law, which sets no clear rules and procedures, but simply states that "financial resources are redistributed through the state budget among the administrative and territorial units of Ukraine taking into consideration their economic, social, ecological, natural conditions and the need to improve their financial security" (Law on the Budget System). And yet such adjustments are often more important for the actual budgets and their execution than formal provisions. Negotiated transfers, especially those intended to equalize fiscal conditions in regions, could be up to two times as high as initial budgets before transfers (Subnational, ..., 1997). Therefore the Ukrainian system of intergovernmental finance, being overly rigid ex ante, is excessively soft ex post, when discretionary fiscal arrangements are negotiated between levels of the government (Polishchuk, 1998a, The Road ... , 1998)

Assessment of the system: Operational aspects

The Ukrainian system of intergovernmental finance features profound imbalances between the revenues and expenditure needs of regional and local governments. This seems to be in contradiction with the requirement of the Law on the Budget System that all lower-level budgets be balanced. In practice, however, this requirement means that revenues match actually incurred expenditures, even if the latter are much lower than those needed to fulfill government obligations mandated by law. Such obligations, according to the Law on Local Self-government, include meeting basic needs of the population in social services at some minimal levels determined by the central government (see below), and in addition making these services free or heavily subsidized for broad segments of population. In the assessment of officials representing Ukrainian regions' financial departments (interviews held in May 1998), revenues of regional governments inclusive of regulated taxes and central subsidies, are still falling dramatically short --by 50 % and more--of expenditures, when the latter are calculated according to the above requirements. It means the Laws on the Budget System and Local Self-government are bound to be broken--not because of non-compliance, but as a matter of objective economic and fiscal realities.

These imbalances are getting worse as the central government is trying to keep its budget deficit within the limits imposed by the IMF, and, being unable to improve revenue collection, is "transferring deficit pressures to subnational levels of government by making fewer resources available to them and giving them unfunded expenditure mandates" (Subnational ... , 1997, p.1). It was noted earlier that the Ukrainian law offers little protection against drastic changes unilaterally introduced by the central government in the system of intergovernmental relations. The center can thus freely manipulate the allocations of revenues and expenditures in pursuit of its short-term political goals. For instance, while the local governments now bear full responsibility for education and health care and most of social safety nets, the recent reassignment of shared taxes, which made VAT fully centralized, was a net transfer of budget revenues from regions to the center, estimated at approximately 30% of local budgets (Subnational ... , 1997). While the central government promised to cover the shortfall by increased subventions to regions, the present fiscal crisis and increased pressure to meet the IMF deficit targets make the fulfillment of this promise unlikely.

Regions cope with these imbalances by various means, but primarily by cutting expenditures that they view as "non-critical"--mostly investments in social infrastructure, payments to utility suppliers, and, as a last resort, wages to public sector employees. By 1997 cumulative regional arrears had risen to over 40% of all subnational budgets, and at present regions are responsible for almost ¾ of arrears by all levels of government (ibid), while regional budgets represent less than 1/3 of consolidated state budget (Martinez, 1998). This is essentially a shift of budget deficit from the center to regions and localities. Such policies are likely to backfire, when escalation of regional debts--either in form of arrears or regional and municipal bonds--will put the central government under pressure to provide bailouts to regions.

Fiscal imbalances of Ukrainian regions are of systemic nature and will persist until at least three fundamental conditions are met:

regions have broader control and discretion over their revenues and expenditures;
assignments of spending responsibilities to regions by upper-level governments are matched by commensurable conditional grants;
jurisdictions and resources of local governments are protected by law and cannot be unilaterally altered by higher levels of government.

At present all of these requirements are grossly violated, which leads to ad hoc cancellations and curtailments of social programs, and the overall malfunctioning of the Ukrainian public sector. The current system also erodes fiscal discipline and accountability at all levels of government. Upper-level governments have a convenient option to reduce budget deficits by offloading their responsibilities as unfunded mandates to lower levels. Local governments, in turn, can always cite lack of funding, which is beyond their control, as a cause of failures to provide required services, pay wages and bills, etc. Local authorities are free to do so because the requirements to meet the needs of their constituencies remain unspecified in the law, and while budgetary norms are used to estimate funding required to maintain 'minimal levels of services' (see below), such norms pose no restrictions on budget implementation (The Road to ..., 1998). Under such conditions institutionalized fiscal imbalances could serve as a front for incompetence, embezzlement, and corruption.

Another major drawback of the Ukrainian system of intergovernmental finance is the lack of clarity and transparency. It was already mentioned that the Ukrainian system of government is excessively complicated, and its legal foundations leave broad gray areas. Running such a system requires a well-developed legal culture and a cadre of public law experts, none of which exists in Ukraine.

Since many budgetary decisions in intergovernmental relations are based on negotiations within the bureaucracy, and such negotiations have no clearly specified rules and procedures and are completely hidden from public oversight, the system is highly non-transparent. The formal component of the system, which could at least in theory be put under control, is playing a diminishing role, because sources of revenues assigned to local budgets by law are insufficient in most of the regions for prescribed expenditures, and growing shortfalls are covered by negotiable subsidies. "The deficit filling philosophy inherent in these negotiations puts a premium on political bargaining skills" (On the Design ... , 1997).

The transparency of revenue assignments was expected to increase after the replacement of the old system of regulated revenues, based on the ad hoc sharing of main taxes, by the new one, when regions keep all of the receipts from personal and corporate income taxes. However, this measure has failed to produce desired results, since the new system still requires massive equalization subventions that are no more rule-based than the earlier sharing of the VAT.

Earlier transfers and sharing rates of regulated taxes were negotiated with the oblasts by the Ministry of Finance. At present, subventions are determined solely by the Ministry of Finance, and the only official channel for oblasts to influence these decisions is to communicate their needs and concerns through members of the national parliament, the Verkhovna Rada, by participating in budget hearings. It therefore appears that Ukraine was able to partly insulate its system of intergovernmental finance from the destabilizing pressure of regional lobbies, so that, "to some extent, the danger of influence by more powerful oblasts may be gone" (Martinez, 1998).

However, one has to be cautious to hail these changes as a radical improvement. First, while the present system officially does not provide for bargaining between the center and oblasts, it still offers no rules as an alternative to intergovernmental haggling, and instead puts transfers at the complete discretion of the center. This produces a biased, 'top heavy' system of intergovernmental finance, increases fiscal uncertainty of lower-level governments, and further exacerbates the gap between their obligations, on the one hand, and opportunities to mobilize revenues and control sources of budget income. Secondly, while the official bargaining channels have been closed, massive transfers of revenue obviously invite informal lobbying, which is deeply rooted in the post-Soviet political culture. Since the central government lacks a popular mandate, and has a very narrow base in the parliament (see e.g. Clover, 1998), it tends tobe willing to enter into political transactions with regions to secure their loyalty through additional handouts (for a description of a similar mechanism in Russia see Polishchuk, 1998b). The end result is that the role of bargaining in intergovernmental relations in Ukraine has hardly diminished (Reform ... , 1997), and opportunities for 'local capture', defined in the World Bank's 1997 World Development Report as "subnational governments' ability to exploit weaknesses of the center" (The State ..., 1997), still abound. "[Many] aspects of the budgeting process are agreed upon, and the possibility of strong regions exerting political pressure, in particular in pre-election periods, increases" (Lyakh, Tkachenko, 1998).

Another major source of non-transparency is the assessments of regional expenditure needs. Such assessments are based on budgetary norms that are supposed to characterize minimal standards of social services guaranteed by the government. So far these norms were calculated by the Ministry of Finance, which uses at its sole discretion various approaches and methodologies, including the antiquated Soviet-style technique, when minimal expenditures are based on existing capacities of public sector facilities. This process is hidden from the regional governments, which are informed only about the resulting estimates and projections (Martinez-Vazquez, 1997).

The transparency of intergovernmental finance further suffers as a result of the proliferation of extra-budgetary funds. These funds, provided for by the Law on Local Self-Government, are estimated to represent up to a quarter of financial resources of local governments (Reform ... , 1997). These funds are often held at banks whose managers are cronies of local government officials, and are excluded from regular procedures of budgetary control and oversight. Precisely because of their non- transparency, little is known about these funds, but they are believed to be a fertile soil for corruption and misappropriation.

Despite recent efforts to base intergovernmental finance in Ukraine on lasting and unambiguous rules, the system remains volatile and unpredictable--so much so that regional officials interviewed by the World Bank's team in May 1998 were unanimous in citing unpredictability of fiscal arrangements as their main concern.

Fiscal unpredictability is present at every stage of budgetary processes in Ukrainian regions and localities, and different sources and causes of uncertainty compound each other. At the first, formal, stage subnational revenues before subventions are estimated as totals of regions' own ('fixed') and shared ('regulated') tax receipts. As mentioned earlier, the first source of revenue is insignificant, whereas the second is under the complete discretion of the central government. The recently introduced changes in the system of 'regulated taxes' that were described in the previous section of the report do not constitute a credible commitment of the central government to keep the current system intact for the foreseeable future. It is only 'hoped' in the draft state budget for 1998 that these changes would become permanent (Martinez, 1998). So far, throughout the whole period of Ukrainian independence "the consolidated budget for subnational governments and those for each individual oblast have been decided under new rules and terms every year" (ibid). This uncertainty of rules of fiscal intergovernmental relations is particularly damaging for the ability of subnational governments to develop long-run plans, since revenue forecasts that span beyond the current fiscal year, let alone cover a period of several years, are highly unreliable. This stalls investments in public infrastructure (weak as they are because of revenue shortfall), and increases risk of subnational borrowing, since regions can neither assure that investment programs, once initiated, will be continued, nor can they provide credible guarantees of their ability to pay back regional debts.

Uncertainty is added at the next stage, when the central government redistributes revenues tentatively assigned to regions through regulated taxes. Since these transfers are not formula-based and are decided solely by the central government, and given their growing size and importance, budgets of donor regions and recipients alike are subject to drastic changes that the affected regions can neither control nor predict. Unlike the previous source of unpredictability, this uncertainty of transfers reflects the absence of rules, rather than their volatility.

Unpredictability does not end when the budget is passed. The capacity of the Ukrainian government to collect taxes remains notoriously poor, which leads to the inability of the center to maintain budgeted expenditures. In 1996 arrears of taxes and contributions to off-budget funds totaled 1/3 of the consolidated budget expenditures. In 1998 the situation got even worse, and in March alone the budget deficit rose by over one per cent of the country's GDP. Under such circumstances the Law on Budget System provides for monthly cuts of earlier planned spending, including transfers to the regions. In addition to these periodic adjustments, the President is about to decree a broad program of spending cuts for the 1998 fiscal year in order to secure a loan from the IMF.

These changes subject lower-level budgets to uncertainty of implementation of the central government's budget. Under fiscal duress, the central government makes ad hoc adjustments, based on its political priorities and perception or regions' abilities to compensate for revenue shortfalls, and regions are the first to feel the squeeze (Interview with Research Triangle Institute experts, May 19, 1998).

Finally, the recent replacement of the value-added tax by the corporate income tax as the main source of subnational budgets' revenues makes the latter highly volatile. Unlike VAT, corporate income tax fluctuates in a broad range, following the economic cycle. With the recent changes regions have become highly vulnerable to such fluctuations, given the central role of the corporate income tax in their budgets (in 1997, when the present tax assignment was first put in place, the corporate income tax yielded over 1/3 of total subnational revenues (Martinez, 1998)). At the same time, regions were deprived of an anti-cyclical anchor in the form of VAT, which generates a relatively steady flow of revenue and is much less sensitive to upturns and downturns of the economy.

In the Ukrainian case the standard arguments against basing subnational budgets on the corporate income tax are further reinforced by high levels of production concentration, typical for industrialized post-Soviet economies. When large firms dominate regional economies--and, as is almost invariably the case in today's Ukraine, experience serious financial problems--regions go under next. If corporate income tax revenues are pooled at the national level, total revenues is much less volatile (Recent ..., 1997). No such risk-spreading is possible within separate Ukrainian regions with their mono-industrial economic profiles. And indeed, the experience of 1997 shows that at least some regions were hit by severe revenue shortfalls as a result of declining profitability of their key breadwinners (ibid). Therefore misallocation of taxes between levels of the government adds uncertainty of tax yield to other factors of unpredictability of regional public finance.

The above analysis shows that the system of intergovernmental public finance in Ukraine has serious operational flaws, which hamper the ability of central and local governments to meet the needs in vital public services, to develop necessary infrastructure, and maintain basic social safety nets.

Dysfunctionality of the system coexists with massive efficiency losses, less visible, but perhaps even more damaging than the drawbacks and mismatches on the administrative side. Unless economic efficiency requirements are properly addressed, fiscal stabilization will require tax increases and spending cuts that will stall economic growth and endanger social and political stability in the country.

Efficiency analysis

The efficiency of intergovernmental public finance has both intraregional and interregional aspects. While the two are closely linked, it is useful to handle them first separately, and then to combine within a unified framework.

Intraregional efficiency requires that the tax burden on the local population and economy is matched with the needs for public sector services and programs, that these programs are tailored to users' preferences, and that the public infrastructure and the tax regime create an attractive climate for private investors, thereby leading to an eventual expansion of the local tax base. These requirements, in turn, lead to the following conditions:

regional authorities are accountable to their constituency;
they have sufficient discretion over local taxes and expenditures;
they operate within clearly established boundaries that neither they nor the central government can transgress.

The first of these conditions aligns the incentives of regional decision makers with the preferences and concerns of voters. In Ukraine it is fulfilled only partly. While local self-governments are formed by elections, and are therefore answerable to the population of cities and municipalities, regional executives are still appointed by the president. These officials serve the dual role of implementing policies of the central government in the regions, and, presumably, representing regional interests at the center. The first of these functions apparently prevails, which is natural, given the way the positions of regional administrators are filled. In particular, regional governors are often engaged in conflicts with mayors of cities and other representatives of local self-governments, defending interests of the center (interview at the Association of Ukrainian Cities on May 19, 1998). Since all of the central government's transfers to subnational units pass through the regional budgets, the latter form a critically important junction of the Ukrainian system of intergovernmental finance, and the incentives of officials who control this junction are ambiguous.

As for the second condition, it appears that local governments have a sufficiently broad discretion with regard to their expenditures, but much less so regarding revenues. Existing legislation and de-facto division of responsibilities put local governments in charge of the main social services and programs (the Law on Local Self-government includes a long and, perhaps, overly specific list of 'exclusive' and 'delegated' powers). There are nevertheless no quantifiable or otherwise measurable standards of these services that local administrations are required to meet. The official minimal norms mentioned earlier are used solely for estimating regions' fiscal needs, and are not mandatory at the implementation stage. This is perhaps fortunate, because, as argued earlier in the report, these norms are fiscally unfeasible and reflect existing capacities of social services, rather than the needs of the population. Being pressed hard to meet the most urgent needs of the population, local governments in Ukraine are free to prioritize their expenditures, and the center seems to be content with this order.

The situation is completely different on the revenue side, where local governments are severely restricted in choosing their tax bases and rates (see the previous section of the report), and "local fiscal autonomy is almost nonexistent" (Reform ... , 1997). The insignificance of local taxes and tight constraints imposed on them deprive subnational governments in Ukraine of the opportunity to manage and customize the tradeoffs between the tax burden and the provision of public infrastructure and services. Control of local governments over this trade-off is of fundamental importance for the efficiency of fiscal decentralization, because it matches high-powered political incentives of elected public servants with adequate means to respond to local needs and reflect regional specifics. This opportunity should be of particular value for Ukraine, given the country's profound interregional diversity of social and economic conditions. At present, this powerful source of efficiency gains remains blocked.

Broader discretion of subnational governments over regional taxes would also allow for experimentation and competitive selection of regional tax regimes. This benefit, however, is only available if labor and capital are sufficiently mobile throughout the country, so that individuals and businesses can 'vote by feet' (Tiebot, 1956), moving to fiscal regimes which are to their liking. As was mentioned earlier in the report, the interregional mobility of population in Ukraine remains low. As for the mobility of capital, the continuing investment crisis renders it hypothetical, at least for some time. These imperfections in the country's institutional and economic setup warrant tighter centralized control over local taxes than would be appropriate in mature market economies. For example, Russia, where conditions are in many aspects similar to those in Ukraine, initially offered to its regions a carte blanche in choosing their tax systems, and an apparent failure of this approach forced the Russian government to impose later binding constraints on local taxes (Fiscal ... , 1996). In Ukraine, however, where local taxes play a negligible role in regional revenues, such constraints need to be relaxed, not tightened.

Whatever limited opportunities to raise revenues from their own sources local governments can have, they might not be interested in doing that, because the system of vertical transfers, and in particular of subventions to regions and localities, is built on the basis of filling gaps. Under this system, an increase in local tax collection will be 'clawed back' by reduced transfers from the upper-level government. "Because subventions represent the marginal revenue source for local governments and are intended to cover the deficit between total expenditures and total own-source revenues, local governments ... are encouraged to overstate their expenditure needs and understate their revenue means" (The Road ... , 1998). These perverse incentives are further strengthened by the fact that the central government lacks adequate estimates of the regions' own fiscal capacities. The calculation of transfers relies on actual records of revenue collection, so that a one-time fiscal effort by a region will produce a 'ratchet effect' and lead to reduced subventions for years to come.

Similar rationales prevent local officials from getting rid of redundant facilities in education and health care, because transfers to regions are based on existing capacities of hospitals, educational institutions etc. As a result, excess capacity in the local public sector, normally a liability for local public finances, becomes a carefully preserved, valuable asset, generating revenue for local government. This is another example of how the existing system makes economically counterproductive behavior fiscally and politically rational for local authorities.

Being unable to expand their revenue collection by conventional means, local officials have broad opportunities to seek additional funding (or resist pending budget cuts) from upper-level governments--in clear violation of the aforementioned condition of operating within clear budgetary boundaries. It was mentioned in the previous section of the report that intergovernmental transfers are not based on formal rules, and the decisions on transfers are largely political. It means that regional budget constraints are soft, and could be substantially relaxed through lobbying and other kinds of informal rent seeking. Rent seeking outperforms productive efforts in the long run as well, since secured concessions serve as a new reference point in future negotiations, thereby improving the region's bargaining position, whereas an increase of locally collected revenues could lead to lasting downward adjustments of vertical transfers.

Overall, rent seeking offers to local officials higher fiscal payoffs than efforts to raise revenues. As a result, public servants allocate their time and efforts to unproductive activities at the expense of efficient utilization and enhancement of the region's fiscal resources. This misallocation of efforts produced by distorted incentives is another source of efficiency losses in the system of Ukrainian intergovernmental finance.

Interregional efficiency of public finance relates to the assignment of taxes and expenditure responsibilities to different levels of the government, the harmonization of fiscal regimes among the regions, and the proper balancing of the requirements of social equity and economic efficiency. From this perspective, Ukraine's main problems are misallocation of some major taxes, and excessively broad redistribution of tax revenues among the regions through the central budget.

Standard principles of efficient tax assignment (see e.g. Shah, 1994) stipulate that progressive taxes serving the objective of income distribution, taxes required for macroeconomic stability, and taxes on mobile factors of production should all be primarily centralized. The present assignment of personal and corporate income taxes in Ukraine entirely to lower-level governments contradicts these principles. The central government's complete surrender to the regions of responsibilities for education, health care, and most aspects of social safety nets are equally inappropriate, since these are all areas of national concern, and local decisions in these fields produce interregional spillovers, fraught with massive efficiency losses.

The government of Ukraine apparently gives a high priority to equalizing fiscal conditions among the regions, and has managed to achieve a significant reduction of the interregional disparities of tax collection; thus, in 1997, the ratio of highest to lowest regional per capita revenues was reduced from an initial 7.5 (before subventions) to 2 (after subventions). However, this mitigation of inequality comes at a high economic cost, because the underlying system of subventions creates strong disincentives that suppress efforts to expand regional tax bases and improve local revenue collection. While the objective of fiscal interregional equity is important on the grounds of social justice, national unity, and economic efficiency, it could be accomplished without such a heavy reliance on direct equalization transfers.

The present transfer system not only reflects the structural distortions of the Ukrainian economy, but perpetuates them by offering broad relief to depressed areas and 'clawing back' results of local efforts. In other words, extra-market redistribution of income through the national budget supplants market-based restructuring of the Ukrainian economy.

Interregional fiscal disparities are further exacerbated by basing regional revenues on the corporate income tax, and could be made less pronounced by a rationalized tax assignment. Indeed, at present there are only a few viable sectors in the Ukrainian economy, such as steel production and some other heavy industries, almost all of them located in the Eastern industrialized regions of the country. Not surprisingly, these regions, generating the bulk of the Ukrainian economy's profits, have considerable fiscal advantages over the rest of the country. Centralization of the corporate income tax would therefore substantially reduce the present interregional fiscal disparity. This is an example of how the same policy measures could bring about simultaneous improvement both on the efficiency and equity sides.

Overall, Ukraine lacks a number of key prerequisites of market-preserving federalism (Weingast, 1995), such as hard budget constraints of subnational units, sufficiently broad powers of regional governments in economic and fiscal policy making, and spatial mobility of labor and capital. These are necessary conditions for efficient economic and fiscal decentralization, involving both intra- and interregional aspects. Under these conditions neither the central nor subnational governments have uncontested monopolies over fiscal and regulatory issues, and regional authorities, being subjected to competitive pressure, are compelled to seek improvement of economic and social conditions in their respective jurisdictions without resorting to economically wasteful rent seeking. The above requirements indicate directions for future reform, which are discussed later in the report.

Reform blueprints and constituencies for change

Widespread disappointment with the present system of intergovernmental finance in Ukraine has produced numerous proposals and blueprints for reform, coming from the central government, the parliament, the regions, as well as from international agencies, including the World Bank and the IMF. The government of Ukraine tends to side with the latter, not in the least in order to meet the conditions for continuing financial assistance.

There is a broad consensus among Western experts about the general directions of reform (see e.g. Martinez-Vazquez, Boex, 1997, Reform ... , 1997). The proposed measures, inter alia, provide for the following changes:

Re-centralization of national taxes, including personal and corporate income taxes. Receipts from these taxes should become general purpose revenues of the central government's budget.

Unambiguous assignment and delineation of responsibilities among the central, regional and local governments, with establishment of mechanisms of conflict resolution in the areas of overlapping jurisdictions.

Replacement of 'regulated' taxes by conditional (categorical) transfers to fund social programs and services of national importance, including education and health care. Sizes of these grants should be based not on existing capacity but on per capita norms, properly adjusted to demographic and other relevant factors.

Increased fiscal autonomy for subnational governments. They should be able to raise their own substantial revenues without affecting the upper-level governments' transfers, so that localities' own fiscal efforts, not grants, determine the size of local budgets on the margin. Composition and rates of local taxes should still be subject to nationally imposed constraints, but the restrictions that are currently in place should be significantly relaxed.

Replacement of the current ad hoc subventions to regions by formula-based equalization transfers, reflecting interregional differences in fiscal capacities and expenditure needs.

Strict adherence to laws and regulations underlying intergovernmental fiscal relations. Regions should be subject to hard budget constraints in their relations with upper-level governments, and at the same time be protected against unwarranted interference in their jurisdictions and arbitrary amendments of existing rules.

Some of the essential components of the reform blueprints are still being debated. One is the choice of local taxes. While it is customary for developed countries, especially those following the Anglo-American fiscal tradition, to base local budgets on the property tax, a broad introduction of such tax in Ukraine could be premature. The real estate market in most Ukrainian localities is still at an embryonic stage, which makes valuation of property problematic. Besides, for many households their income is disproportionally low in relation to the property they own, and under such conditions a real estate tax would pose an excessively heavy burden on household budgets. Often suggested alternatives are local sales taxes or surtaxes on the personal income tax, calculated as a percentage of income tax payable to the central government. It is possible that such 'piggy-back' local taxes might be gradually replaced by a property tax when economic conditions make this feasible.

Another unresolved issue is the role of oblasts, which form the intermediate tier of the Ukrainian system of government. Today oblasts effectively control the allocation of the central government's transfers to cities and municipalities, and in addition participate jointly with lower units in the provision of social services. Some radical reform proposals, making references to provisions of the Constitution and the Law on Local Self-government, assign to oblasts a purely technical role of disbursement, according to prescribed rules, of the central government's transfers to local self-governments, and of undertaking at the request of municipal units joint infrastructure projects funded by voluntary contributions of participating municipalities. These proposals, however, are mostly politically motivated (see below) and could be in violation of requirements of economic efficiency. First, municipal governments are generally too small to utilize efficiently economies of scale in the public sector (Bird et al., 1995) and to internalize public sector interjurisdictional spillovers. Second, voluntary contributions towards joint projects will likely be insufficient because of free riding. Prevention of free riding is in fact one of the main rationales for the centralization of provision of public goods, and proposals to deny oblasts any administrative autonomy apparently ignore this important argument.

Surprisingly missed from the reform agenda is the mobility of population and labor as a potent means to solve some of Ukraine's most urgent fiscal problems, and in particular to decrease the need for costly equalization transfers. Migration to regions with better economic opportunities would reduce the demand for public support in depressed areas, and at the same time release efficiency gains by correcting the misallocation of factors of production created by decades of central planning. Last but not least, a mobile population facilitates dissemination across the country of efficient tax and expenditure regimes in the regions. In the past Ukrainians have shown a high propensity to travel, even beyond national borders, in pursuit of better economic conditions:

examples range from the massive emigration to Canada at the turn of the century to large Ukrainian communities formed around Siberian oil fields to numerous Ukrainian guest workers in today's Russia. One can therefore assume that Ukrainians would be equally receptive to migration opportunities within their homeland. To facilitate migration, the remaining administrative barriers to movement of population should be lifted, and an efficient information system of employment opportunities nationwide put in place. The government could also offer to potential migrants some economic incentives, using for this purpose some of the funds currently spent for equalization transfers.

While laws and regulations concerning intergovernmental public finance are actively debated and receive much of attention of domestic policy makers and international experts, problems of enactment, implementation and enforcement of new and old rules remain on the periphery of the current discussions. The experience of Ukraine and other Newly Independent States clearly demonstrates that these are issues of fundamental importance and should be addressed simultaneously with drafting new laws. Otherwise, such laws are rejected by legislatures or remain only on paper, lacking mechanisms and procedures of implementation, as well as constituencies interested in enforcement.

Addressing these issues requires a stakeholder analysis that would identify forces in the economy, politics and society which will be strongly affected by the reform of intergovernmental fiscal relations and are able to influence reform's outcome. The preferences of key economic and political players should be juxtaposed with the normative requirements of economic efficiency, equity and provision of quality public services. Revealed discrepancies between the general goals of reform and directions of stakeholder pressure should be taken into account in the reform program.

One of the most worrisome conclusions of such an analysis is that while various parties to the process of decentralization of government in Ukraine have different, often conflicting, views and objectives, none of these parties is concerned with the overall efficiency of decentralized public sector and intergovernmental finance. The central government is preoccupied with reducing its budget deficit and building political coalitions in lieu of missed popular support. Oblast officials strive to preserve their roles in the evolving system of government, while representatives of cities and municipalities vie for fiscal autonomy and oppose involvement of any upper-level government (unless requested by municipalities) in the administration of social services and programs.

As argued earlier in the report, the current system of intergovernmental fiscal relations in Ukraine causes numerous operational problems and violates basic requirements of economic efficiency. Operational drawbacks of the system are highly visible and directly affect regional officials and their constituencies; this, in turn, creates a strong grassroots pressure for corrective measures. On the other hand, efficiency losses are not visible in everyday life and can be fully assessed only in comparison with a rationally organized system of intergovernmental public finance, which the country never had in the past. A reform that would make revenue and expenditure assignments more clear and predictable, without even addressing economic efficiency concerns, would therefore receive broad support, and there would be little pressure for further changes.

However, neglect of efficiency requirements in designing intergovernmental public finance is a luxury that Ukraine can ill afford. One reason is that when the government is struggling to run a broad set of social programs against the backdrop of an acute fiscal crisis and deep economic recession, efficiency of the public sector becomes vitally important. Secondly, a poorly designed system of decentralized revenue and expenditures disorients market agents and distorts their allocation decisions. If an economy is sufficiently mature and its structure by and large conforms to market needs, such distortions will cause only limited damage, since reallocation would occur only on the margin of a more or less efficient core. The Ukrainian economy, however, requires a profound restructuring, and such distortions would be much more damaging, leading to vast efficiency losses for years to come.

The economic efficiency of fiscal decentralization, being a matter of national scope and concern, is a responsibility of the central government. Unfortunately, policy making at the national level still lacks proper appreciation of modern economic principles, and remains heavily influenced by the traditions of central planning. For example, the draft Law on Local State Administration, which undoubtedly reflects current practices, provides for a broad range of government interventions in the private sector. The latter include various aspects of socio-economic development, control over industry and agriculture, management of property and entrepreneurship, control of firms' decisions that "may result in changes of the ecological and demographic situations, as well as bring other consequences". The draft law, in the full spirit of central planning, puts local administrations in charge of developing "balances of the labor, material [and] other resources, local construction materials, fuel etc." The draft imposes practically no constraints on these kinds of government involvement, especially when it invokes an "and others" clause, and leaves the private sector practically defenseless against attempts to put the market under control of the government.

Liberal economic ideas have a much broader currency and support at the level of cities and municipalities. This is in part due to the fact that the old establishment was able largely to preserve its influence at the national level and in oblasts, whereas democratic opposition strengthened itself locally (Brown, McGuire, 1997). For example, situations when liberal mayors are confronted with communist governors of oblasts are common in Ukraine (interview with V. Pynzenyk, Chairman of the Institute of Reforms, May 20, 1998). Therefore local self-governments form a natural constituency for reform, capable of transforming the system of intergovernmental finance 'from bottom up'. Another advantage of such an approach--advocated, among others, by influential Association of Ukrainian Cities (interview with M. Pittsyk, Chairman of Association, May 19, 1998)--is the opportunity, intrinsic to decentralized government, to experiment with different policies, and to provide for competitive selection of those that will prove to be most efficient. It is further argued (above-cited interview with V. Pynzenyk) that it will be easier to win parliamentary approval for a local experiment than for a similar measure nation-wide. When best policies will prove in practice their superiority, they will be adopted by other localities and eventually be codified post facto, in the common law tradition, by a national legislative act. The center plays in this process a passive role by simply accommodating changes that have been initiated at the grassroots level.

While this scenario has its indisputable merits, it is unlikely that an efficient decentralization of government could be achieved without an active involvement of the center. The latter has an important role in the process of competitive selection described above, which is to maintain a fiscal and regulatory environment where efficient local policies will indeed outperform those based on political influence and rent seeking. So far this condition is apparently lacking in Ukraine. According to the above-cited sources, the central government and its representatives in oblasts are interested in preserving the status quo, because it's easier to exercise political control over fiscally dependent cities and municipalities. Recalcitrant mayors are subjected to criminal charges, which, even if dismissed in courts, serve to discredit the attempts to reform local government and finance. On the other hands, the cities that 'play by the rules' and keep good relations with oblast and central officials, are rewarded for their loyalty, and not interested in the transparency that would bring these relations to the fore (Interview with Research Triangle Institute experts, May 19, 1998).

This trend could be reversed by a broad public discussion of policy alternatives, which has proven to be a potent means of advancing a system of fiscal and administrative decentralization that serves the needs of society (The State, 1997). Such discussion could be facilitated by efforts to disseminate among policy makers, public servants and opinion leaders information on modern approaches to intergovernmental finance. Many Ukrainian officials are still captives of old approaches and policies. This can be seen, for example, from the rejection of interregional differentiation of tax rates as allegedly detrimental to national unity, or the lack of appreciation of the role of interregional mobility of population in maintaining an efficient fiscal decentralization (interviews held in Ukraine in May, 1998). Politicians, government officials and public at large should be particularly alerted about waste in the present system of fiscal decentralization, and the importance of economic efficiency as a criterion for assessing reform proposals.

In addition to general principles and blueprints, the public should be informed about the accomplishments and failures of policies adopted in various regions (such a need was particularly stressed by representatives of the Association of Ukrainian Cities and the Reform Institute interviewed in May, 1998). This would create pressure upon local officials to implement approaches that have proven to be successful in other regions. Public awareness would thus work toward facilitating spontaneous dissemination of progressive fiscal innovations. In addition, the public should have access to information on the activities of local administrations and intergovernmental relations. 'Sunshine laws' would complicate behind-the-scene bargaining between the center and regions, and foster accountability and transparency at all levels of government.

Finally, it is essential that all major stakeholders be properly represented in policy debates and in the enactment of legislative acts that lay the foundations for decentralized government in Ukraine. For example, the weakness of constitutional provisions on local self-government is attributed to the fact that the interests of cities and municipal units were not adequately voiced during the parliamentary debates on the constitution (Tkachuk et al., 1997). At present subnational units seek political consolidation (e.g., within the Association of Ukrainian Cities) in order to influence national policy making. That should lead to a more balanced system of intergovernmental relations, correcting the current bias towards fiscal overcentralization.

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